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February 14, 2006

## **AGENDA ITEM 6a**

### **TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** New Enhanced Indexing Initiative
  - II. PROGRAM:** Global Equity
  - III. RECOMMENDATION:** Staff requests approval to issue a Request for Proposal (RFP) with "Spring-Fed Pool" and annual review contract features for relaxed-long enhanced index managers. Staff will seek Investment Committee approval for the entire recommended group of managers. Wilshire's opinion letter is shown in Attachment 1. Previous information agenda items are shown in Attachments 2 and 3.
- III. ANALYSIS:**

#### **Executive Summary**

This is an action item seeking approval for staff to conduct an RFP for relaxed-long enhanced index U.S. equity managers. This strategy would complement the existing lineup of domestic active and enhanced equity strategies. The strategy expands the available opportunity set by allowing managers to exploit security mispricing for both overpriced and underpriced securities. The strategy should improve returns while reducing risk to the overall program.

The Investment Committee will be asked to vote on the entire recommended group of managers rather than on individual managers. The RFP will stipulate that the Investment Committee may decide to interview the finalists at its discretion. The decision on whether to conduct Investment Committee interviews can be made at the time staff presents its recommendation on the group of managers to include in the pool.

### **Background**

At the November 14, 2005 Investment Committee staff presented an information item that is included as Attachment 2. That agenda item explained how relaxing the long-only constraint is an improvement over traditional long-only equity portfolios and why inclusion of this strategy should help CalPERS achieve its performance objective for the global equity asset class. Included in that agenda item as attachments were: (1) the Wilshire opinion letter; (2) a paper titled Discussion on the Issue of Shorting; and (3) a document outlining the minimum qualifications a manager must have for inclusion in the search.

At the December 12, 2005 Investment Committee meeting, staff provided another information item that included discussions on: (1) the impact of the long-only constraint; (2) a comparison, including information ratios, of the proposed strategy versus a long-only strategy using simulated returns; (3) actual results of the proposed strategy; and (4) a comparison of the strategy to a market neutral absolute return strategy. That information item is also included as Attachment 3.

### **Initiative's Impact on the Risk of the Fund**

As directed by the Investment Committee at its December 2005 meeting, the Risk Management Group tested the impact this strategy would have on the overall risk of the CalPERS fund. In order to assess the impact on both the total and active risk of the fund, CalPERS obtained the holdings of the 130%/30% portfolio highlighted in Table 2 of the December 2005 Information Item. This portfolio inceptioned in July 2004 and is considered an acceptable proxy for the risk of the overall strategy since it is close to the maximum allowable shorting of 35%. For purposes of this test it was assumed that the funding for this new strategy would come from a reduction in the internally managed U.S. equity index fund.

The results of the test showed that adding this strategy would have little to no effect on total and active risk of the fund depending on the amount of assets allocated. As more assets are allocated to the strategy above what is currently planned, the total risk to the fund actually decreases slightly while the active risk to the total program increases slightly. This confirms staff's expectations that adding this strategy would further diversify the program while improving the overall expected return. The entire report by the Risk Management Group is included in the next section of this agenda item.

**Risk Management Viewpoint (Prepared by CalPERS Risk Management/Asset Allocation Unit)**

**Objective:** To test the potential impact of adding a new strategy of including Long/Short Enhanced Indexing Managers to the total risk and active risk of the CalPERS Fund.

**Summary Conclusion:** There is very minimal impact to the risk of the total fund by adding this strategy. If CalPERS were to fund about \$2 billion towards this strategy, then based on the holdings in the sample portfolio, you begin to see a reduction in the total risk of the fund and an increase in the active risk.

**Methodology:** We were able to obtain a sample US equity portfolio with a strategy of holding US equity securities of 130% in long positions and 30% in short positions. This portfolio was considered an acceptable prototype and close to what is anticipated to be the maximum shorting strategy. In order to neutralize the risk impact of this investment strategy, as opposed to affecting any changes in risk due to shifts in asset allocation as a result of funding the new equity managers, it was assumed the new portfolio would be funded by an equal reduction in the US equity passive account. We performed tests whereas the new portfolio was funded at levels of \$1, \$2, \$5 and \$10 billion. As the portfolio was funded, the US Equity passive account was reduced by the same levels. The changes in portfolio funding were configured within the context of the actual CalPERS holdings and run through the Barra TotalRisk model and CalPERS Risk Measurement System.

**Results:** This type of strategy can potentially impact risk in two ways: 1) increase the equity active risk by shifting funds to managers who invest in overweight and underweight positions relative to the equity benchmark, and 2) change the overall risk of the fund as the risk introduced by the long/short strategy interacts with the other risks in the fund. Because of the size of the CalPERS total fund, and the diversification of investments within the total fund and within the global equity portfolio, shifting funds to this investment strategy will have minimal impact to the funds risk profile. The impact of these potential risks does depend upon the amount of funds reallocated to this investment strategy.

The values presented in the table below represent the forecasted risk (%) over the next twelve months. There is virtually no impact to the total risk of the US equity asset class. This is because the asset class currently is enormously diverse, and the total risk of US Equity is generally determined by the effective allocation to US Equity which does not change with the addition of this new strategy. As funds are diverted more from the passive benchmark fund to long/short managers there is the potential for increased active risk, or greater difference in expected returns than from the policy benchmark. The Total Plan could potentially experience a small decline in total risk as more funds are shifted to this strategy as it appears that the

risks introduced through this strategy generally offset other risks in the fund. The total plan active risk could also increase as a result of reallocating funds to this investment strategy which results in larger deviations from the policy benchmark.

<b>TOTAL RISK</b>	<b>Without</b>	<b>\$1 Billion</b>	<b>\$2 Billion</b>	<b>\$5 Billion</b>	<b>\$10 Billion</b>
US Equity	12.8	12.8	12.8	12.8	12.8
Total Plan	8.8	8.8	8.8	8.8	8.8
<b>ACTIVE RISK</b>	<b>Without</b>	<b>\$1 Billion</b>	<b>\$2 Billion</b>	<b>\$5 Billion</b>	<b>\$10 Billion</b>
US Equity	0.42	0.42	0.42	0.46	0.59
Total Plan	0.72	0.72	0.72	0.74	0.77

### **Expanding the Opportunity Set Improves the Information Ratio**

The proposed strategy will allow risk-controlled, quantitative, enhanced index type managers the ability to go up to 135% long and 35% short in the portfolio while maintaining a market-like portfolio beta. This strategy allows managers to build portfolios with higher information ratios due to the larger investment opportunity set and improved diversification of active over- and underweights. Relaxing the long-only constraint would give the best managers another degree and dimension of freedom in which to express their views on securities for CalPERS' benefit. The strategy should improve the performance of CalPERS' externally managed public equity assets.

### **Risks**

As previously noted by staff and Wilshire, there are risks associated with this strategy including, but not limited to, the costs and complexity of selling stocks short. However, CalPERS currently has analytical systems to monitor the risk exposures in the portfolios. In addition, CalPERS will limit the extent to which a manager can relax the long-only constraint.

### **Manager Search Process**

The initial scoring of the proposals will be based on the managers' responses to the RFP. Following the scoring of the RFPs, managers with the highest scores will be invited for in-person interviews. After the interviews, staff will recommend to the Investment Committee a group of enhanced index managers that would make up the initial pool. The Investment Committee can decide to interview finalists at the time the recommendation is made.

Staff recommends hiring a group of managers whose strategies produce active returns that exhibit a low correlation to each other and the other managers currently in the U.S. active and enhanced index manager pools. This will provide a

diversified portfolio of active returns. The strategy will require extra monitoring by staff, particularly with regard to the risk targets. CalPERS currently has in place risk management systems that can efficiently monitor the managers. Allocation of assets among these managers, and subsequent rebalancing decisions, will be recommended by staff based on analysis that encompasses all relevant factors.

### **Criteria for Selection**

The following criteria will be used for manager selection:

- Managers with positive active returns, commensurate with the risk incurred, that have a low correlation to one another;
- The alpha engine underlying the manager's long-short strategy produces positive active returns in a long-only portfolio as well;
- A well reasoned investment philosophy and process and the ability to demonstrate why it should add value over the benchmark;
- A quantitative process for portfolio construction and risk control;
- Depth of investment talent and a convincing strategy to retain top talent;
- Experienced securities traders and evidence of ability to trade in a cost-effective manner for large institutional portfolios;
- Experience with short selling;
- Risk system comparable to what managers of risk managed absolute return strategies use;
- Competitive fee arrangements;
- A desire to work for CalPERS and deploy adequate and high caliber resources to the relationship.

In consideration of the Board's policy on Board scoring, staff would recommend that 200 points be allocated for staff (not including fees) and 200 points be allocated for the Investment Committee, to be applied in the event that the Committee decides to interview and score the bidders. The 200 points allocated to staff would consist of 100 points allocated to the scoring of the bidders' proposals and 100 points allocated to staff's onsite visits or interviews. Staff would seek input from Wilshire to develop the questionnaire used in the scoring of the bidders' proposals.

### **Benefits of a Spring-Fed Pool of Managers**

Staff recommends that the contracts be awarded through a Spring-Fed Pool process as a better way to include all eligible managers and optimize the opportunity set. This means that additional managers may be considered after the initial RFP and funding. As time goes on, new proposals will be considered on a periodic basis using the same criteria and analysis used to select the initial group of managers for additional funding. Managers demonstrating the appropriate quantitative risk and return profile would then be brought to the Investment

Committee for review and approval. The term of the Spring-Fed Pool would be five years.

### **Annual Review Contracts**

Staff recommends the use of annual review contracts, which provide for an undefined duration, for this RFP. This would be consistent with the contracting procedure used for all other investment management contracts. This recommendation is necessary to fulfill CalPERS' fiduciary duties to its members because the use of annual review contracts is a more efficient use of CalPERS staff and board time and other resources. The award of contracts without a defined duration is allowed under Board Resolution 92-04B-4.

### **Conclusion and Summary**

- Staff recommends the Investment Committee issue an RFP for U.S. equity enhanced index managers that are allowed to do limited shorting as the next step in improving the performance of CalPERS' externally managed equity program.
- A Spring-Fed Pool feature is requested in the contracting process in order to facilitate the re-optimization of the portfolio in the future, as well as the inclusion of new managers who may qualify at a later date.
- Staff will seek Investment Committee approval for the entire recommended group of managers in each category. The Investment Committee can decide to interview finalists at the time the recommendation is made.

## **V. STRATEGIC PLAN:**

This item is consistent with the Strategic Plan: Goal IX, achieve long-term, sustainable, risk adjusted returns.

**VI. RESULTS/COSTS:**

This item is brought to the Investment Committee in order to enhance risk-adjusted returns and improve the Global Equity opportunity set. The allocation to these managers would come primarily from assets that are managed on a passive basis. In addition, some funding may be obtained from a reduction in the assets of CalPERS' current external managers or from cash inflows. Funding amount is dependent on a number of variables including the number of managers eligible to be included in the pool. Staff will have a specific recommendation on the amount of assets to allocate at the time it presents its manager recommendations to the Investment Committee. Current staffing within Global Equity is sufficient to develop and execute this initiative.

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